

**MINUTES
of the
FIFTH MEETING
of the
INVESTMENTS AND PENSIONS OVERSIGHT COMMITTEE**

**October 16, 2013
Room 307, State Capitol
Santa Fe**

The fifth meeting of the Investments and Pensions Oversight Committee (IPOC) for the 2013 interim was called to order by Representative Jim R. Trujillo, chair, on Wednesday, October 16, 2013, at 9:22 a.m. in Room 322 of the State Capitol in Santa Fe.

Present

Rep. Jim R. Trujillo, Chair
Sen. George K. Munoz, Vice Chair
Sen. Sue Wilson Beffort
Sen. Jacob. R. Candelaria
Sen. Steven P. Neville
Sen. Bill B. O'Neill
Rep. Jane E. Powdrell-Culbert
Rep. William "Bill" R. Rehm
Rep. Luciano "Lucky" Varela

Advisory Members

Rep. Donald E. Bratton
Rep. Miguel P. Garcia
Rep. Roberto "Bobby" J. Gonzales
Rep. Emily Kane

Absent

Rep. Larry A. Larrañaga
Sen. Carroll H. Leavell
Rep. Henry Kiki Saavedra
Sen. William P. Soules

Sen. Carlos R. Cisneros
Rep. William "Bill" J. Gray
Sen. Stuart Ingle
Sen. Timothy M. Keller
Rep. Tim D. Lewis
Rep. Patricia A. Lundstrom
Sen. Mary Kay Papen
Sen. William H. Payne
Sen. John C. Ryan
Sen. Michael S. Sanchez
Rep. Sheryl Williams Stapleton

Guest Legislator

Rep. Alonzo Baldonado

Staff

Claudia Armijo, Staff Attorney, Legislative Council Service (LCS)
Amy Chavez-Romero, Assistant Director for Drafting Services, LCS
Pam Stokes, Staff Attorney, LCS
Ric Gaudet, Researcher, LCS

Guests

The guest list is in the meeting file.

Handouts

Handouts and other written testimony are in the meeting file.

Wednesday, October 16**Capital and Overview of Capital Outlay Requests to Date; Water and Other Local Project Issues**

Linda Kehoe, principal analyst, Legislative Finance Committee (LFC), and Ryan Gleason, tax policy and research director, Taxation and Revenue Department, discussed funding of capital projects. Ms. Kehoe began by reporting to the committee that senior severance tax bonding capacity is expected to decrease \$38 million in 2014, to \$186 million. General obligation bonding capacity, based on an assumed proposed flat mill levy in 2014, will be \$165 million. State agency requests for capital improvement projects have not been totaled by the Department of Finance and Administration yet, but Ms. Kehoe said that state agencies typically request between \$700 million and \$800 million. Local governments are expected to request at least \$1.2 billion to meet their top priorities for capital projects.

Many local projects continue to be thwarted by not having sufficient funding to complete a phase. Many projects are funded by the legislature with only 10 percent to 20 percent of their funding needs, and those projects tend to remain underfunded for years.

Mr. Gleason described the difficulties encountered by local governments trying to get funding for water and wastewater projects. There are many different entities and many different funding sources for these projects, each with different eligibility guidelines, funding cycles, loan and grant agreements, oversight and reporting requirements. Small entities must spend a large portion of their staff time devoted to getting funding for a project. There is a huge amount of federal funding each year for water and wastewater projects that reverts because of timing issues and the fact that federal requirements are more stringent than state funding requirements. Mr. Gleason suggested that there is plenty of funding for projects, but there is a systemic lack of coordination between funding entities to ensure that available money is spent and that projects are fully funded. He suggested a model of funding projects that prioritizes local financing first, followed by federal financing, then by state loans and last by state grants. Loans should be preferred over grants because they have a much lower overhead cost and tend to be repaid easily

by revenues generated from the water or wastewater project. Finally, he recommended that projects should be phased and funded in a way that each phase of a project is operational.

Questions and comments from committee members included the following.

- The LCS' capital outlay request form needs to include information about other secured funding sources so that legislators and staff can ascertain how much a project actually needs to be fully funded. Ms. Kehoe said that LFC and LCS staff are revising that form to require more specific information from local entities. She said that the LCS capital outlay database might also become publicly accessible.

- Local governments are in the habit of requesting funding for several projects each year, knowing that there is probably not even enough money available to fully fund one of those projects.

- Many local governments are not doing any local financing for projects, preferring to ask the legislature for funding.

- There is very little auditing of local government capital projects.

- Why does so much federal money revert instead of being allocated to New Mexico projects? Mr. Gleason said that the process of obtaining federal loans and grants is much more cumbersome than most state processes. Most entities request state funding first. Then, if that does not happen, they look to federal funding. However, usually by the time the legislative funding cycle is over, much of the federal money has already reverted, and the window for applying for funding is very narrow. Ms. Kehoe said that each funding source is very protective of its power, so there is not very much collaboration in funding projects. New Mexico is backwards compared to other states in how it funds capital projects.

- How can collaboration between funding entities be accomplished? Mr. Gleason said that until local governments are required to seek federal funding prior to state funding, much of that federal funding will revert. Another issue is that the Water Trust Board funding cycle, which requires legislative approval for each project, makes it difficult to collaborate with other funding entities on projects. There will need to be statutory changes in order to achieve the goal of funding collaboration.

- Capital projects should be required to undergo what is known as "value engineering" to ensure that costs for projects are legitimate.

- How can an entity determine if it has met its auditing requirements, according to the governor's recent executive order prohibiting expenditure of funds for capital projects if an entity is in violation of certain audit requirements? Mr. Gleason said that if an audit finding relates to an entity's ability to correctly spend money, a state agency is prohibited from releasing money to

that entity. The executive order has had the result of many local governments fixing their audit problems. However, Mr. Gleason acknowledged that many rural local governments are unable to hire an auditor because of auditors' unwillingness to travel to remote areas.

- How do other states handle federal funding for water and wastewater projects? Mr. Gleason said that in most states, federal funding for those projects is the only external funding source, so local governments have no choice but to comply with the burdensome application and reporting requirements.

Severance Tax Bonding (STB) Program

Stephanie Schardin Clarke, director, State Board of Finance (SBOF), gave the committee an overview and history of the STB program. Severance taxes have been imposed in the state since 1937 and provide a significant funding source for general government, trust funds and capital improvements. Since 1959, certain severance tax receipts have been used to back bonds issued for capital improvements. In 1973, the modern STB program was created, with the creation of the Severance Tax Permanent Fund (STPF) and the restriction of issuance of bonds to 50 percent of the prior year's deposits into the STPF.

In 1999, a new class of bonds from the Severance Tax Bonding Fund was created as a result of the *Zuni* lawsuit, which required the state to establish a uniform method of funding public school construction. An additional 45 percent of the prior year's deposits was set aside for that program, and the bonds issued have mostly been short-term supplemental bonds, also known as "sponge" bonds. More than \$2.4 billion in school construction bonds have been issued since 1999. That money would have otherwise been deposited into the STPF, which is mostly used as a long-term revenue stream for the general fund.

Any remaining money from the statutory set-asides for bonding is deposited into the STPF. Ms. Clarke explained the volatile nature of deposits into the STPF, which have ranged from nothing to \$160 million in the course of one fiscal year. Bonding capacity is determined by the prior fiscal year's revenue, and that revenue is determined by the often-volatile energy production sector. Large increases in severance taxes do not translate that same fiscal year into increased bonding capacity, but they are used to determine the following year's capacity. The excess cash in the bonding fund is then deposited into the STPF. In similar fashion, a boom year in energy followed by a steep decline the next year might mean that the bonding capacity is increased, but bonds can only be issued if enough cash is available in the bonding fund to cover the cost of the bonds. The bonds issued that year will generally expend all of the available cash in the bonding fund, which means that no money is deposited into the STPF.

Questions and comments from committee members included the following.

- Why did the SBOF issue long-term supplemental severance tax bonds for public school construction rather than sponge bonds? Ms. Clarke said that in 2010, the Public School Capital 5

Outlay Council requested more money than was available in cash from the bonding fund. The SBOF decided to issue long-term bonds that year to cover the shortfall.

SBOF staff was requested to provide the committee with information on the percentage of public and private land and the percentage of each sector that contributes oil and gas revenue to the state government. SBOF staff was also requested to provide revenue modeling of the STPF, looking at the long-term impact of changing the current 4.7 percent annual distribution from the STPF to 5.8 percent.

Presentations and Panel Discussion on Legislative Planning for New Governmental Accounting Standards Board (GASB) Reporting Requirements with a Focus on the Impact on Local Governments

The committee heard from a large panel of representatives from state, local and national organizations and governments on the impact on local governments of the new GASB accounting and reporting rules.

National Conference of State Legislatures (NCSL)

Jeff Hurley, NCSL, began the discussion by describing the pension funding recommended guidelines developed by the NCSL and several other national organizations. With the new GASB Statements 67 and 68, there are now three broad sets of calculations that state and local governments need to perform regarding pension liabilities: accounting, bonding and funding. The group decided that developing pension funding guidelines was important because the new GASB statements broke the link between accounting and funding standards. The pension funding guidelines include recommendations to have a funding policy that is based on an actuarially determined contribution; to build funding discipline into the policy to ensure that promised benefits can be paid; to maintain intergenerational equity; to make employer costs a consistent percentage of payroll; and to require clear reporting to show how and when pension plans will be fully funded.

RBC Capital Markets

Paul Cassidy, RBC Capital Markets, discussed Moody's Corporation's recent changes to how it rates local governments for creditworthiness. In anticipation of the new GASB rules requiring local governments to fully report pension liabilities on their financial statements, Moody's and other ratings agencies have begun adopting adjustments to their analysis of state and local government pension data. Moody's determined that pensions are a growing source of credit pressure, with the general increase in liabilities coupled with the stagnant growth of revenues. An increase in pension liability relative to revenue is a negative credit factor. However, pension liability is just one of many rating factors in the overall bond rating for a local government. Moody's made four significant changes to how it analyzes a government's pension liabilities: liabilities of cost-sharing plans are allocated to local governments based on their proportionate share of the total plan liability; the discount rate used to measure long-term liabilities is based on a high-grade corporate bond index; the valuation of assets uses the market

value instead of "smoothed" asset valuation; and the calculation uses a standardized amortization schedule.

Moody's recently requested more detailed information from its local and state government customers regarding pension liabilities. A few governments in New Mexico were faced with the possibility of a credit downgrading after that information was reported, which caused a fair amount of panic in those finance departments. Mr. Cassidy detailed the experience of Las Vegas, New Mexico, which accidentally reported both the employer and employee share of pension funding, resulting in a threatened credit downgrading because that city's liabilities appeared much higher than normal. The city's original rating was subsequently confirmed.

Santa Fe County

Katherine Miller, county manager, Santa Fe County, described the county's recent experience with another threatened Moody's credit rating downgrade. Santa Fe County has a relatively high cost for its pension plans, dating back to union agreements from many years ago to pick up much of the employee share of pension plans. The county also has several funding sources to pay for its pension liability, in addition to the county general fund. In April 2013, just before the county was to begin the issuance of general obligation bonds, Moody's threatened to downgrade Santa Fe County's rating because the company only looked at county general fund revenues to cover pension liabilities. When the error was pointed out to Moody's, the company still refused to restore the rating until a thorough analysis had been completed. Needing to issue the bonds quickly, Santa Fe County decided to get a bond rating from Standard & Poor's instead, which gave the county its highest bond rating ever of AA+.

City of Santa Fe

Marcos Tapia, finance director, City of Santa Fe, also witnessed a downgrading of the city's credit rating by Moody's in July 2013. Mr. Tapia said that the city has not used Moody's ratings to secure bond financing since 2008. Moody's did not contact anyone at the city for information regarding its pension liabilities or funding sources and apparently also neglected to look at other city funds used to pay pension liabilities.

City of Albuquerque

Lou Hoffman, finance director, City of Albuquerque, said that the increased burden of GASB Statements 67 and 68, coupled with the requirements of 66 other GASB rules, will mean that it will be difficult for Albuquerque to meet the December 1 deadline to submit its comprehensive annual financial report (CAFR). The Public Employees Retirement Association (PERA) will also need to provide timely pension liability information to its members. He suggested that the state change Rule 2.2.2.9 NMRA, requiring a December 1 CAFR, to January 1. In addition, he suggested that the legislature authorize investment of local government trust funds using the Prudent Man Rule, rather than the more restrictive provisions of Section 6-10-10 NMSA 1978.

State Treasurer

State Treasurer James Lewis reported to the committee that the National Association of State Treasurers asked Moody's to delay implementation of its pension liability calculation methodology until after implementation of GASB Statements 67 and 68. Moody's declined to delay its rule changes. Currently, each of the three main rating agencies has a different methodology to assess pension liabilities of state and local governments. He said that Moody's caused Santa Fe County financial damage by releasing its preliminary report recommending that the county's bond rating be downgraded. He also said that Moody's new methodology of requiring a much lower discount rate than has been used will mean that funded ratios of pension plans could be shown in significantly worse shape. For example, North Carolina has been using a discount rate of seven percent to measure its pension plans, which showed its plans to be 100 percent funded. Using Moody's new methodology shows the state pension plans being funded at 65 percent.

Educational Retirement Board (ERB)

Jan Goodwin, executive director, ERB, reported to the committee that the ERB is implementing the reporting requirements of GASB Statement 67 early. The ERB will calculate the June 2012 pension liability with the new methodology, then recalculate the June 2013 liability taking into account the legislative changes made to pension plans in 2013. This early implementation will give its employer members two years of advance notice of the new financial data.

PERA

Wayne Propst, executive director, PERA, said that the PERA will do everything possible to provide timely and accurate information to its employer members. The PERA had already made a presentation to the committee about implementation of the GASB rules at an earlier meeting.

New Mexico Association of Counties (NMAC)

Santiago Chavez, finance director, NMAC, said that his organization will work closely with the PERA to get actuarial statements to counties. He expressed concern that Moody's new methodology for calculating pension liabilities will show new, unexpected liabilities to local governments, which may hurt their credit ratings.

Questions and comments from committee members included the following.

- What methodology is Moody's using to come up with its new discount rate? Mr. Hurley said that the AA corporate bond rate, currently around 5.5 percent, will be used, rather than a commonly used discount rate of seven percent, or a rate that reflects investment practices of a given fund. In addition, amortization is not being considered, and the practice of "smoothing", used to minimize the impacts of year-to-year volatility in investments, is not being allowed. He said that Moody's will be comparing local governments across the country, so a big economic downturn should have minimal relative impacts on credit ratings.

- Some pension funds, especially those facing large unfunded liabilities, take bigger risks in investing their funds. Ms. Goodwin said that Moody's will use the same discount rate for every pension fund, regardless of how each fund is actually invested.

- Can Santa Fe County change the 75 percent "pick-up" pension payment for its employees? Mr. Propst said that the pick-up provisions are not required by statute; the board of county commissioners could change that provision, subject to a collective bargaining agreement.

- State and local governments will now need to report pension liabilities in three different ways. Mr. Hurley said that the most important pension liability number is the actuarially determined calculation of how to fund the pensions; reporting for bond ratings or to meet GASB requirements is much less important.

- What is the GASB? Why does it have so much power? State Treasurer Lewis said that the GASB, a private organization, is the counterpart to the Financial Accounting Standards Board, which sets accounting standards for the private sector. The GASB has power in part because the ratings agencies have indicated that if a governmental entity does not comply with GASB rules, the entity will not be rated for creditworthiness. That would be devastating to the ability of a government to issue bonds for basic operations. Mr. Cassidy said that the GASB wants to ensure that state pension liability is accurately reflected on local governments' CAFRs in proportion to their share of the liability. Mr. Tapia said that in order to maintain their licensure, accountants must comply with GASB rules.

- Will the new GASB rules require fully funded pension plans to change their policies? Ms. Goodwin said that funding pension plans should be based on actuarially sound studies of each plan. GASB rules will not affect those policy decisions. However, the changes that Moody's has made will often mean that bond ratings for many local governments will be downgraded.

- There may be some sort of collusion between the GASB and the ratings agencies.

Minutes

The minutes of the September 9, 2013 meeting of the committee were approved without changes.

Adjourn

There being no further business, the committee adjourned at 4:00 p.m.